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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-658

ASARCO INCORPORATED (formerly
The American Smelting and Refining Company),
Appellant,

v.

MONTANA DEPARTMENT OF REVENUE
OF THE STATE OF MONTANA, *Appellee.*

**On Appeal from the
Supreme Court of Montana**

BRIEF OF THE COMMITTEE ON STATE TAXATION OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE AS AMICUS CURIAE IN SUPPORT OF APPELLANT'S JURISDICTIONAL STATEMENT

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I. INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation of the Council of State Chambers of Commerce as amicus curiae in support of the jurisdictional statement in the above-captioned case. Both parties to this proceeding have consented to the filing of this brief, as evidenced by the letters reproduced as Exhibit A, pages 1a-2a, *infra.*

II. OPINIONS BELOW

The opinion of the Supreme Court of the State of Montana is reported at 567 P.2d 901 (1977). Copies of that opinion, the Supreme Court of Montana's denial of a petition for rehearing, and the unreported findings of fact and opinions of the District Court for the First Judicial District of the State of Montana and the State Tax Appeals Board of the State of Montana (both of which ruled for appellant) are appended to Appellant's Jurisdictional Statement as Appendix A.

III. INTEREST OF AMICUS CURIAE

The Council of State Chambers of Commerce (COUNCIL), organized in 1932, consists of 33 Chambers of Commerce (29 state and 4 regional Chambers). The Committee on State Taxation (COST), one of four advisory committees of the COUNCIL, consists of 110 corporate members which conduct a substantial portion of the interstate and international business of the United States. One of COST's principal activities has been to work with the states and others toward developing fair and equitable national standards in the income allocation and apportionment aspects of state taxation.

Member companies of COST are thus representative of that part of the nation's business section which is most directly affected by state taxation of interstate and international business operations. COST is therefore vitally interested in cases such as this one which present issues significantly affecting the uniformity, certainty and fair apportionment of state and local taxes.

The particular interest of COST in this case is that it presents the following substantial questions:

(1) Whether a member state of the Multistate Tax Compact, acting in conjunction with the Multistate Tax Commission, may lawfully impose taxes pursuant to an audit by the Multistate Tax Commission acting under the purported authority of the Multistate Tax Compact if this Court rules that the Compact is unconstitutional in *United States Steel Corp.* v. *Multistate Tax Commission,* Dkt. No. 76-635, prob. juris. noted, 429 U.S. 1088 (1977).

(2) Whether a state may, consistently with the Constitution's Commerce and Due Process Clauses, subject a corporation doing business in that state, but domiciled elsewhere, to a license or income tax on investment income of the corporation which is earned outside of that state and has no connection with the business conducted in that state.

(3) Whether, consistently with the above provisions of the Constitution, a state may impose a license or income tax under a so-called "combined report" theory which has the effect of subjecting a corporation doing business in that state to tax on the income of its United States and foreign affiliates even though the affiiiates conduct no business in that state and derive all of their income from sources outside of that state.

Reaffirmation by this Court of the constitutional standards for fair apportionment in state taxation of multistate and multinational businesses in cases of this type is urgently needed for the orderly growth of interstate and international commerce. It is also needed to provide a reasonably consistent and fair system of

taxation throughout the nation in this era of rapidly increasing state and local revenue demands, which system will allow each state to receive its just share of the total tax contribution of the nation's business sector. Finally, such review by this Court is absolutely essential in view of the existence of the Multistate Tax Compact, a confederation of 19 western states created for the acknowledged purpose of blocking Congress—the only avenue other than this Court available for resolution of the interstate tax problem—from enacting any legislation to protect interstate and foreign commerce from discriminatory state taxation.

IV. ARGUMENT

A. The Need for Constitutional Standards

It has been eighteen years since this Court last decided a case involving the constitutional limits on a state's power to tax the income of an out-of-state corporation doing business within the state and admittedly subject to its taxing jurisdiction. See *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450 (1959). Cf. *General Motors Corporation* v. *District of Columbia,* 380 U.S. 553 (1965). During that eighteen year period, the worst features of our complex and inequitable interstate tax system have worsened[1] as social, economic and political pressures have combined to place ever-increasing demands upon our state treasuries.[2] The response of many state tax officials to these

[1] Hearings Before the Subcommittee on State Taxation of Interstate Commerce of the Senate Committee on Finance, 93rd Cong., 1st Sess. 260-284 (1973); Cahoon and Brown, "The Interstate Tax Dilemma", 26 *National Tax Journal* 187 (1973).

[2] State tax collections totaled $89.3 billion in 1976 compared to $24.2 billion in 1964. State corporate income tax collections are now more than 16% of federal corporate income tax collections; in 1966, state collections were only 7%.

pressures has been to probe the outer limits of the state taxing power by applying arbitrary and expansive definitions of that power. As Justice Frankfurter stated in his dissent in *Northwestern States Portland Cement Co.* v. *Minnesota, supra,* 358 U.S. at 477, "[t]he solution to these [interstate tax] problems ought not to rest on the self-serving determination of the States of what they are entitled to out of the Nation's resources."

It is not uncommon for officials of the Multistate Tax Commission—the most important contributor to the impetus toward extraterritorial taxation—to decry any proposed restriction on the Commission's efforts to transform the interstate tax system as threatening the states with serious injury or destruction.[3] When such a siege mentality prevails it is understandable that the self-serving determination to maximize revenues may overcome long-established constitutional

[3] For example, see the testimony of John Lobdell, Chairman of the Multistate Tax Commission, before the Foreign Relations Committee in opposition to the pending U.S.-United Kingdom Tax Treaty. Hearings on the Convention with the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. (1977) (not yet printed) [hereinafter cited as Treaty Hearings].

The Ninth Annual Report of the Multistate Tax Commission, p. 9 (1976), stated:

> "The Treasury Department has included in the pending tax treaty with the United Kingdom provisions which would shackle the States in their efforts to improve their tax administration capabilities . . . . Similar provisions are being incorporated into treaties which are currently being negotiated with other nations."

principles defining jurisdiction to tax. It is unlikely under these conditions that self-discipline will prove sufficient to contain within constitutional limits the gradual expansion of the area in which state taxing power is asserted.[4] To the contrary, it is abundantly clear that the member states of the Multistate Tax Compact, in conjunction with the Multistate Tax Commission, will continue to expand those boundaries until this Court announces that a constitutional limitation has been exceeded.

The aggressive approach taken by some states in recent years is reflected by the Court's present docket, which includes a variety of important cases presenting, in combination, most of the important issues in this area. These cases include:

> *United States Steel Corp.* v. *Multistate Tax Commission,* Dkt. No. 76-635, prob. juris. noted, 429 U.S. 1088 (1977), which questions the extent to which the states may combine without congressional consent to control the taxation of interstate and foreign commerce through the Multistate Tax Compact and the Multistate Tax Commission;

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[4] For example, notwithstanding the thrust of this Court's decision in the *General Motors* case, *supra,* Florida, Wisconsin, New York and Massachusetts have all taken steps since 1971 to shift their rising tax burdens to out-of-state businesses by giving *double* weight to the sales factor in the three-factor formula customarily used to apportion interstate business income. 10B Fla. Stat. Ann. § 220.15(4) (Supp. 1977); 2B Mass. Ann. Laws, Ch. 63, § 38 (Supp. 1977); N. Y. Tax Law § 210.3 (McKinney Supp. 1976); Wis. Stat. Ann. § 71.07 (Supp. 1977). In addition, a bill providing for double weighting of the sales factor was introduced in the Illinois Senate on April 7, 1977. The bill, S.B. 737, came up for a final vote by the Senate on May 26, 1977, but was recommitted to the Senate Revenue Committee for further study of its revenue impact.

> *Moorman Mfg. Co.* v. *Bair,* Dkt. No. 77-454, prob. juris. noted, —— U.S. —— (Nov. 14, 1977), which concerns the constitutional validity of an income-apportionment formula based entirely on sales;
>
> *Chase Brass & Copper Co.* v. *Franchise Tax Board,* Dkt. No. 77-582 (docketed Oct. 20, 1977), which questions the validity of a "combined reporting" theory under which the income of a company not subject to a state's taxing power may be apportioned and taxed to a related company doing business within the state; and
>
> The instant case, which questions the validity of (i) a state tax imposed on investment income earned outside the state by a foreign corporation doing business within the state, (ii) a *Chase Brass* "combined reporting" adjustment and (iii) a Multistate Tax Commission audit under the Multistate Tax Compact, the constitutionality of which is currently at issue before this Court in the *U.S. Steel* appeal.

It is submitted that this spectrum of problems will continue to confront this Court, and taxpayers will be faced with ever-broader assertions of state power, until the Court agrees to consider and resolve the above issues. Given the vagaries of litigation, however, the Court may not again be presented with so complete an assortment of state income tax issues on a single docket. Thus, the Court has an opportunity to consider these important and interrelated issues together, rather than in isolation, and to provide definitive constitutional guidance which will greatly reduce the burden of administering and litigating the validity of state tax stat-

utes for years to come. COST therefore strongly urges the Court to accept this opportunity.

Our specific views on the three issues in the instant case are as follows:

B. Extraterritorial Investment Income

1. Origin of the Multistate Tax Commission's Rule

The Multistate Tax Compact, a confederation of 19 states,[5] was created in 1967 in response to the enactment by Congress of P.L. 86-272 (Act of September 14, 1958, 73 Stat. 555)[6] and the subsequent congressional report, which was highly critical of the states' handling of the multistate tax problem and which urged a congressional solution.[7] The Compact was created for the acknowledged purpose of "killing off" any further federal legislation dealing with protection of interstate and foreign commerce from discriminatory state taxation, thereby leaving the resolution of the problem to this Court.[8]

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[5] The member states are: Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington.

[6] This statute, which was adopted by Congress as a stop-gap measure, established minimum jurisdictional standards for state taxation, 15 U.S.C. §§ 381-384 (1970), and directed that a congressional investigation of interstate taxation be made. 15 U.S.C. § 381 n. (1970).

[7] Report of the Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, H.Rep. No. 1480, 88th Cong., 2d Sess., Vol. 2, p. 559 (1964). See also the other volumes of the Report: H. Rep. No. 1480, 88th Cong., 2d Sess.. Vol. 1 (1964); H. Rep. No. 565, 89th Cong., 1st Sess., Vol. 3 (1965); H. Rep. No. 952, 89th Cong., 1st Sess., Vol. 4 (1965).

[8] Statement of Eugene Corrigan, Executive Director of Multistate Tax Commission, in "Taxation of Interstate Business", *Proceedings of Tax Foundation, Seminar* (April 16-17, 1970), p. 17. See also Multistate Tax Commission, First Annual Report, p. 1 (1968).

The Compact creates the Multistate Tax Commission, an independent administrative body empowered to promulgate regulations and adopt practices to implement the interstate tax policies of the Compact. The Compact grants the Multistate Tax Commission broad subpoena powers as well as the power to conduct interstate tax audits.

The draftsmen of the Compact copied the Uniform Division of Income for Tax Purposes Act (UDITPA), 7 U.L.A. 365 (1970), a model statute approved in 1957 by the National Conference of Commissioners on Uniform State Laws. Under UDITPA, passive, nonbusiness income items such as royalties, interest and dividends on investments are allocated to the appropriate state according to situs. All of the remaining income is then labeled business income and is apportioned according to an equally-weighted three-factor formula among the states with jurisdiction to tax such income. Although the Compact copies UDITPA, the Multistate Tax Commision has promulgated regulations and practices that obliterate the key elements of UDITPA by calling for full apportionment of the non-business income of multistate taxpayers, thereby eliminating the distinction provided by UDITPA between non-business and business income.[9]

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[9] Multistate Tax Newsletter, No. 30, issued by the Multistate Tax Commission, September, 1971. The Multistate Tax Commission in its Seventh Annual Report (1974) explained its action as follows: "Full apportionment involves applying the [apportionment] formula to all income *regardless of source or nature*". (Emphasis supplied; p. 47.)

Traditionally, passive non-business income, such as royalties, interest and dividends on investments, is specifically allocated for purposes of state corporate income tax to the state where the recipient has its corporate domicile.[10] This means that, under traditional interstate practice, passive non-business income is subject to taxation only in the state of domicile. Such income, not being earned by the business operations of the taxpayer, is not subject to tax through apportionment in other states where those operations are conducted.

Eugene Corrigan, Executive Director of the Multistate Tax Commission, has noted that the traditional interstate tax practice of allocation of passive-type investment income according to its situs was initially developed by states on the eastern seaboard, which has been "the situs of the corporate movement in America." [11] Corrigan indicated that the development of the corporation required "the concomitant devising of a tax system appropriate for corporations." The traditional interstate tax practice of specific allocation of passive, non-business income, therefore, evolved as the system most "appropriate for corporations."

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[10] For cases illustrating the operation of this traditional practice, see, e.g., *Avco Corp.* v. *Wasson*, 230 S.E.2d 614 (S.C. 1976); *American Bakeries Co.* v. *Johnson*, 259 N.C. 419, 131 S.E.2d 1 (1963); *Cargill, Inc.* v. *Spaeth*, 215 Minn. 540, 10 N.W.2d 728 (1943); *California Baking Corp.* v. *State Tax Commission*, 97 Utah 367, 93 P.2d 463 (1939). A tax policy research study published by the U.S. Treasury in 1976 also indicates that allocation of non-business income is the long-standing method of taxation employed by the states. See *Essays in International Taxation*, p. 201 (1976).

[11] Multistate Tax Commission, Seventh Annual Report, p. 46 (1974).

The 19 members of the Multistate Tax Compact, on the other hand, are primarily western states with few large commercial centers within their boundaries. No eastern industrial state is a member. The members of the Compact are opposed to the traditional practice with respect to allocation of non-business income because it conflicts with their own "self-serving determinations" as to "what they are entitled to out of the Nation's resources." Accordingly, the Multistate Tax Commission, pursuant to Article IV of the Compact, promulgated regulations eliminating this traditional legal system and adopting instead the full apportionment by formula of all interstate income.

The Montana tax involved in this appeal was assessed pursuant to an audit by the Multistate Tax Commission of Appellant's Montana tax returns. The assessment was based upon the Multistate Tax Commission's regulations requiring full apportionment of all income rather than upon the controlling Montana statute (Section 84-1503, R.C.M. 1947) requiring separate allocation of non-business income according to situs as required by UDITPA.

The background and purpose of UDITPA and the Multistate Tax Commission's deliberate attempt to misconstrue it were recently summarized in Garrison, "Toward a Consensus on Apportionable vs. Allocable Income", 28 *The Tax Executive* 41 (October, 1975), as follows (footnotes omitted):

> "The problem of dividing the total net income of a multistate firm among the states entitled to impose a tax on it has existed ever since Wisconsin enacted the first modern state net income tax in 1911. For all those years this problem has been the subject of study and comment.
>
> * * *

The National Tax Association has wrestled with the problem of allocation and apportionment for more than a half century. As early as 1922, an NTA committee recommended specific allocation of interest, dividends, rents, and royalties to their geographic source. Their report declared: 'They form no part of the trading profit and do not need to be apportioned by formula since they can readily be specifically allocated to their proper sources'.

In 1957, the National Conference of Commissioners on Uniform Laws adopted the Uniform Division of Income for Tax Purposes Act (commonly referred to as UDITPA), which has since been enacted by over half the states. Under UDITPA, non-business income is allocated, item by item, to each appropriate state according to the situs of the item. All of the remaining income is then labeled business income and is apportioned, according to a three-factor formula, among the states with jurisdiction to tax such income.

Business income is defined in UDITPA as income arising from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

The classes of income which are to be specifically allocated under UDITPA, if they do not constitute business income for the taxpayer, are dividends, interest, rents and royalties, and capital gains.

At the time UDITPA was adopted, the statutes and administrative practices for most of the states required direct allocation to specific states of dividends, royalties, and interest income especially where such income had not arisen in the main course of the taxpayer's trade or business. There

was a rather extensive body of case law and literature in support of this traditional legal position. The framers of UDITPA were aware of these precedents and practices but, as indicated by Sections 4 through 8 of the Act, they evidently preferred to make no radical departure from existing law and administrative practices with respect to allocation and apportionment.

Professor William J. Pierce, the principal draftsman of the Uniform Act (UDITPA), has indicated that the distinction between business and nonbusiness income in the act and was intended to codify the existing pattern of legislation. In an article in 35 *Taxes—The Tax Magazine* 749 (1957), Professor Pierce stated:

> 'Sections 4 through 8 of the act provide for the allocation of four types of non-business income to specific states, rather than apportionment on the basis of a formula. The reason for this treatment, which is representative of the existing pattern of legislation, is that it is felt that these items of income can appropriately be attributed to a specific state.'

* * *

The push for full apportionment of all income by formula perhaps had its origin in 1966 with the so-called Interstate Taxation Bill (H.R. 11798, 89th Cong., 2d Sess.), which was introduced in Congress soon after the publication of the Willis committee report. Under this so-called Willis bill, the entire income, both business and nonbusiness, had to be divided among the states by a uniform apportionment formula. This radical departure from the prevailing practice with respect to allocation was one of the most controversial parts of the Willis bill.

The momentum for Congressional legislation starting with the Willis bill caused the formation

in 1967 of the Multistate Tax Compact, a confederation of 21 states created primarily for the purpose of blocking the enactment of any federal legislation with respect to the interstate tax problem. Article IV of the Compact adopts the Uniform Act (UDITPA) as its rules governing allocation and apportionment. However, the Multistate Tax Commission, which is created under the Compact, adopted regulations in 1971 requiring virtual full apportionment of all income, irrespective of the class of income or its geographic source. Sections 4 through 8 of the Uniform Act (UDITPA) were simply read out of the statute by regulation. The Commission's regulations instead reflect the view that all of a corporation's interstate taxable income is business income and should, therefore, be apportioned."

The Multistate Tax Commission immediately recognized that its adoption on June 19, 1971 of regulations eliminating the distinction between business and non-business income would conflict not only with UDITPA but also with the various state tax statutes. As evidence of this recognition, the Commission adopted at the same meeting a resolution urging that Article IV of the Compact as well as the laws of the member states be revised to conform to the Multistate Tax Commission's regulations.[12] However, neither the Compact nor the statutes of member states (including Montana) have been amended as suggested by the Commission.

Mr. William D. Dexter, Chief Counsel of the Multistate Tax Commission, discussed this attempt to bypass UDITPA in Dexter, "Taxation of Income from Intangibles of Multistate-Multinational Corporations", 29 *Vand. L. Rev.* 401, 407 (March, 1976):

[12] Multistate Tax Newsletter, No. 30 (September, 1971).

"The UDITPA distinction between 'business' and 'non-business' corporate income appears to lack any rational basis and has created confusion for taxpayers and tax administrators alike. The Multistate Tax Commission has, therefore, concluded that the distinction should be eliminated by treating all corporate income as apportionable business income.* * * Since UDITPA, an integral part of the Compact, specifically contemplates the designation of at least some income as non-business income, and since the Multistate Tax Commission is reluctant to recommend amendments to the Compact that would be necessary to implement the 'full apportionment' concept under UDITPA, the Commission has chosen to rely for the present upon its regulations to clear up as much of the confusion as possible."

This statement by the Multistate Tax Commission's Chief Counsel is tantamount to an admission that the Commission is trying to change *state* law through *Commission* regulations.

In a letter dated September 24, 1971, Eugene Corrigan, Executive Director of the Multistate Tax Commission, stated with respect to the Commission's regulations:

"While none of you apparently like to see full apportionment of all corporate taxable income, many of you on the business as well as the state side are concerned about the problems which may arise legally in making the change."[13]

The utter failure to heed the concerns conceded by Corrigan is what gave rise to this case.

[13] Hearings Before the Subcomm. on State Taxation of Interstate Commerce of the Senate Comm. on Finance, 93rd Cong., 1st Sess., 269-270 (1973).

As noted above, the Multistate Tax Compact includes UDITPA's allocation rules. Accordingly, when the various state legislatures adopted the Compact, they also adopted UDITPA. Now, without further action by the legislatures, the Multistate Tax Commission is attempting, through its regulatory power, to completely vitiate that legislative intent. This is, perhaps, the most insidious danger of the Multistate Tax Compact, *i.e.*, the Commission's issuance of regulations without regard to legislative intent, its implementation of those regulations through its joint audit program and its attempt to force such audits upon taxpayers through its subpoena power. The presence of such awesome cumulative powers in a body lacking political responsibility to the electorate is a threat to federal supremacy and to the sovereignty of the states themselves.

2. Constitutional Standards

Notwithstanding the Multistate Tax Commission's "confusion", the UDITPA provisions are consistent with the long-standing constitutional doctrine that a state cannot tax income "in no just sense attributable to transactions within its jurisdiction". *Hans Rees' Sons, Inc.* v. *North Carolina,* 283 U.S. 123, 134 (1931). See *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113 (1920).

The Fourteenth Amendment to the Constitution provides that "No State shall . . . deprive any person of life, liberty, or property, without due process of law . . . ." As corporations are "persons" within the meaning of the Fourteenth Amendment (*Pembina Consolidated Silver Mining and Milling Co.* v. *Pennsylvania,* 125 U.S. 181 (1888)), it follows that states cannot compel corporations to pay taxes without due process.

The applicability of the Due Process Clause to state tax matters was discussed in *Connecticut General Life Insurance Co.* v. *Johnson,* 303 U.S. 77 (1938). In that case, where California was prevented from imposing its gross premium tax on a Connecticut corporation's non-unitary, non-California reinsurance contracts, Justice Stone stated:

> "[T]he limits of the state's legislative jurisdiction to tax, prescribed by the Fourteenth Amendment, are to be ascertained by reference to the incidence of the tax upon its objects rather than the ultimate thrust of the economic benefits and burdens of transactions within the state. As a matter of convenience and certainty, and to secure a practically just operation of the constitutional prohibition, we look to the state power to control the objects of the tax as marking the boundaries of the power to lay it. Hence it is that a state which controls the property and activities within its boundaries of a foreign corporation admitted to do business there may tax them. But *the due process clause denies to the state power to tax or regulate the corporation's property and activities elsewhere.*" [Emphasis supplied; 303 U.S. at 80-81]

It is a constitutional axiom that state taxation of foreign corporations doing business in the state must be limited so as to avoid taxation of extraterritorial values. As this Court stated in *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission,* 390 U.S. 317, 325 (1968):

> "The taxation of property not located in the taxing State is constitutionally invalid, both because it imposes an illegitimate restraint on interstate commerce and because it denies to the taxpayer the process that is his due. A State will not be permitted, under the shelter of an imprecise alloca-

> tion formula or by ignoring the peculiarities of a given enterprise, to 'project the taxing power of the state plainly beyond its borders'. *Nashville, C. & St. L. R. Co.* v. *Browning,* 310 U.S. 362, 365 (1940). Any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State. *Fargo* v. *Hart,* 193 U.S. 490, 499-500 (1904)." [Footnotes omitted.]

In determining the situs of intangibles, the basic constitutional rule is "mobilia sequuntur personam" (*i.e.,* movables follow the person). Thus, intangibles are "localized at the owner's domicile for purposes of taxation" if they do not have a "business situs" in another state. *Wheeling Steel Corp.* v. *Fox,* 298 U.S. 193 (1936); *First Bank Stock Corp.* v. *Minnesota,* 301 U.S. 234 (1937); *Curry* v. *McCanless,* 307 U.S. 357 (1939); *Chestnut Securities Co.* v. *Oklahoma Tax Commission,* 125 F.2d 571 (10th Cir. 1942), *cert. denied,* 316 U.S. 668 (1942).

On the other hand, formulary apportionment of the *trading profits* of a business is accepted as constitutionally sound in the ordinary case because it is frequently difficult to ascertain in any other way the income from in-state business activities which constitute one or more steps in a series of transactions culminating in the realization of income outside the state. See *Skelly Oil Co.* v. *Commissioner of Taxation,* 269 Minn. 351, 131 N.W.2d 632 (1964); UDITPA, *supra.* If the amount of in-state income depends on accounting hypotheses or an assumed division of income between branches of an integrated business, this Court justifiably refrains from intervening on the side of the corporate taxpayer simply because its calculation of in-state income varies from that of the taxing authorities.

There is a limit, however, to the extent to which expediency can allow a state to disregard jurisdictional limits. Where income arises from a distinct and identifiable source, it can and should be specifically allocated (*i.e.,* attributed or assigned) to that source because this will produce the most accurate and precise determination of the taxpayer's true tax liability. If a specific allocation can be made because there is no dispute as to the source of the income item in question, apportionment by formula is not necessary and should not be permitted.

3. Appellant's Investment Income Is Not Taxable In Montana

In the present case, Appellant reported and paid Montana tax on the investment income it earned from money on deposit in Montana and securities deposited with Montana agencies. It allocated its remaining investment income to the state of its commercial domicile or the state where the investment property was located. See J.S., App. A, pp. 22a-23a.[14] Both the State Tax Appeal Board and the State District Court found as a fact that *all* of Appellant's remaining investment income was derived from sources outside Montana and could, as a practical matter, be "segregated" from the income earned within Montana. J.S., App. A, pp. 23a, 43a.

None of Appellant's investment property was functionally related in any fashion to the conduct of Appellant's business activities *in Montana.* On this record, it is indefensible to "apportion" any of such investment

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[14] J.S. references are to the Appendix to Appellant's jurisdictional statement.

income to Montana. However, the Montana Supreme Court has approved that treatment by characterizing the investment income as "business" income which was allegedly related in various indirect ways to Appellant's business activities *outside* Montana, thereby upholding the Multistate Tax Commission's practice of treating *all* income as business income subject to formula apportionment regardless of the state taxing statute. See J.S., App. A, pp. 11a-13a.

Similar attempts to tax an out-of-state corporation on investment income have been firmly rejected by state Supreme Courts in *Square D Co.* v. *Kentucky Board of Tax Appeals,* 415 S.W. 2d 594 (Ky. 1967); *Gulf Oil Corp.* v. *Clayton,* 267 N.C. 15, 147 S.E. 2d 522 (1966); *American Bakeries Co.* v. *Johnson, supra; Commonwealth* v. *ACF Industries, Inc.,* 441 Pa. 129, 271 A.2d 273 (1970),[15] and cases cited in footnote 10, *supra.* The Montana Supreme Court's holding in the case at hand directly conflicts with these cases. Therefore, for this reason alone, this Court should act to resolve the conflict.

It is no coincidence that the Montana Department of Revenue has adopted the Multistate Tax Commission's position that *all* income is apportionable "business" income. Montana is not the commercial domicile of many multistate corporations. Adoption of a rule apportioning investment income away from its sources to a state in which the taxpayer has tangible property, payroll or sales will, on balance, subject a great deal more income to the state's tax than the state could reach through application of a proper rule. Most of the

[15] But cf. *Commonwealth* v. *Emhart Corp.,* 443 Pa. 397, 278 A.2d 916 (1971), *appeal dismissed,* 404 U.S. 981 (1971).

great commercial and industrial states, on the other hand, will continue to require that investment income be taxed at its source. For this reason it is futile to speculate whether Montana's system of extraterritorial taxation might somehow be valid if all states applied the same formula—that is, if the states of commercial domicile which have the recognized power to tax the investment income failed to do so.

No single formula will ever appeal to the self-interest of every state. States will continue to experiment with apportionments and allocations designed to maximize the amount of taxable income generated under each state's particular circumstances. Misallocation of income thus results, not as an unintended by-product of neutral formulae consistently applied, but as the necessary corollary of each state's action in pressing its jurisdiction to the furthest arguable limit. While this scramble may be viewed as a contest between states or regions—agricultural vs. industrial, consumer vs. producer, West vs. East—in actuality it is the multistate taxpayer who must pay tax on more than 100% of its income for the privilege of engaging in interstate commerce. It is this chaotic misallocation which requires the intervention of this Court, to define more clearly the limits of state taxing jurisdiction.

C. The So-Called "Combined Report" Theory

Regulations and practices of the Multistate Tax Commission call for use of the combined reporting theory.[16] Under this concept of taxation, the income of

[16] See, Commission Regulations IV, 2(b)(2) ("Application Article IV: Combined Report"), which is reproduced in Appendix B, Reply Memorandum of Appellants, *U. S. Steel Corp.* v. *Multistate*

a group of affiliated corporations earned in several states and countries is "combined" and subjected to taxation in those Compact states in which one of the affiliated corporations is present. Taxes are imposed on the apportioned overall income of the affiliated corporations without regard to whether the income being taxed was earned by a taxpayer subject to the jurisdiction of the Compact state.

The Multistate Tax Commission, pursuant to its regulations and practices, included the income of six U.S. and Canadian subsidiaries in Appellant's apportionable income, and Montana tax was assessed on such income. To the extent that combined reporting increased the tax which Appellant alone would have paid, the undeniable effect of the procedure is to tax part of the subsidiaries' income in Montana, despite the fact that the subsidiaries were *admittedly* not subject to Montana's taxing jurisdiction in their own right.[17] See J.S., App. E, pp. 62a-63a.

The argument of Montana—that the purpose of combination is not to tax the income of companies beyond the State's jurisdiction but to measure Appellant's Montana income more accurately—is mere sophistry. None of the subsidiaries carried on any business in Montana. It has not been shown that they con-

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Tax Commission, supra. Frederick Cappetta, the Audit Coordinator for the Commission, stated in Multistate Tax Commission, Seventh Annual Report, p. 56 (1974), that the Commission would continue to pursue the combined reporting concept in its audits.

[17] Compare this Court's June 24, 1977 holding that an assertion of in rem jurisdiction by Delaware in a derivative action lacked "minimum contacts" and violated the Due Process Clause. *Shaffer* v. *Heitner*, 53 L.Ed. 2d 683 (1977).

tributed in any way to Appellant's Montana operations, or that Appellant dealt with them at less than arm's length in transactions outside Montana. Because there has been no evidence that Appellant's ownership and control of the subsidiaries were used to shift income from Appellant to the subsidiaries through artificial business arrangements outside of Montana, Appellant cannot be required to pay tax on the reported income of its subsidiaries any more than it could be required to pay tax on the reported income of unrelated suppliers or customers with whom it had similar dealings.

Appellant's separate income was accurately reflected on its own tax returns. The additional income taxed through combined reporting belonged to its subsidiaries and was taxable by states other than Montana or, in the case of foreign subsidiaries, by the country in which it was derived.[18]

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[18] As pointed out in Miller, "State Income Taxation of Multiple Corporations and Multiple Businesses", 49 Taxes-The Tax Magazine 102 (1971), the accepted way of dealing with the problem of artificial or non-arm's length transactions between related parties is to recompute the income of each affiliate as though the transactions in question had been on an arm's length basis. Section 84-1508 of the Revised Codes of Montana gives Montana statutory authority to make such adjustments. Significantly, Montana did *not* attempt to invoke this statutory authority in the present case. Invocation of this remedy would not have been unduly burdensome, since the state has full access, under Treasury Dept., Internal Revenue Service, Disclosure of Official Information Handbook (IRM 1272) §§(12)52, (12)55:(5), Exhibit (12)00-1, 1 CCH Internal Revenue Manual [Administrative] pp. 2235, 2241, to information as to intercompany adjustments made by the Internal Revenue Service pursuant to Section 482 of the Internal Revenue Code of 1954, the corresponding provision of federal law. Instead, Montana went beyond the federal approach and beyond its own authority in its efforts to tax extraterritorial income.

The attempt by the Multistate Tax Commission and the Montana Department of Revenue to impose combined reporting requirements is particularly disturbing when, as in this case, the combination includes one or more corporations organized and operating in foreign countries, and thus has international as well as federal implications.[19] The disruptive effect of the combined report on interstate and foreign commerce is well illustrated by the recent testimony before the U.S. Senate Committee on Foreign Relations concerning the U.K.-U.S. Income Tax Treaty presently before the U.S. Senate for ratification, which treaty precludes the imposition of combined reporting on domestic enterprises controlled by U. K. residents.[20] For example, Assistant Secretary of the Treasury Laurence N. Woodworth noted that the combined reporting practices produced complaints from our treaty partners, violated the spirit of existing United States tax treaties, varied from internationally-accepted practices, produced possible multiple taxation by the states, and resulted in extraterritorial taxation by the states.[21] The U.S.-U.K. treaty demonstrates that the United King-

[19] The U. S. Treasury Department has received numerous requests from various nations seeking protection from combined reporting. See Report of the Department of State, June 8, 1976:

> "This method of assessment, which includes the burden of producing worldwide records of all of the affiliated companies, has raised many objections by our treaty partners and we are now seeking to deal specifically with this problem in our treaties." [2 CCH *Tax Treaties* ¶ 8103DC]

[20] Treaty Hearings, *supra*, n.3.

[21] *BNA Daily Report for Executives*, No. 140, J-10, at J-14 (July 20, 1977).

dom believes, and the United States agrees, that combined reports result in an improper extension of the taxing authority of the states.[22] It is unfortunate that this overreaching should have gone uncorrected to the point that the United Kingdom had to resort to such an extraordinary remedy as the treaty process. The treaty, however, will be of no direct benefit to many multistate taxpayers, who, like Appellant, must seek relief in the courts. It is for the benefit of these taxpayers, as well as of the federal system, that this Court is respectfully requested to exercise its jurisdiction and declare more fully the constitutional limits of state taxation.

D. Multistate Tax Commission Audit Status

This appeal provides a sequel to the *U.S. Steel* case, which was argued orally before this Court on October 11. 1977, and involves the issue whether congressional consent is required to the Multistate Tax Compact because of its actual and potential effects upon the national and international interests of the United States. The instant case not only raises the same constitutional issue as that involved in the *U.S. Steel* case but also shows in a concrete factual setting how the Multistate Tax Commission applied its invalid regulations to Appellant by means of an interstate tax audit conducted by the Commission itself under powers of subpoena.

[22] In discussing combined reports, counsel for the Multistate Tax Commission has represented to this Court that no audit ever conducted by the Commission touches on the subject matter of the U. K. treaty. *United States Steel Corp.* v. *Multistate Tax Commission, supra*, Transcript of Oral Argument, p. 28 (argued Oct. 11, 1977). The facts of this case demonstrate that counsel could not have intended to imply that the Commission had never combined U.S. and foreign affiliates.

Accordingly, it is very important for this Court to clarify the effect of the deep Multistate Tax Commission involvement in pending cases if this Court resolves the *U.S. Steel* case, *supra,* by holding—as we believe it should—that the Multistate Tax Compact is unconstitutional.

CONCLUSION

For all of the foregoing reasons, COST urges this Court to note probable jurisdiction in the present case and give plenary consideration to all three questions discussed in Appellant's Jurisdictional Statement.

Respectfully submitted,

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APPENDIX

EXHIBIT A

STATE OF MONTANA

DEPARTMENT OF REVENUE
MITCHELL BUILDING
HELENA, MONTANA 59601

October 28, 1977

Multistate Tax Commission
and
Committee on State Taxation of the
Council of State Chambers of Commerce

Gentlemen:

ASARCO, Inc. has filed an appeal to the United States Supreme Court from the Montana Supreme Court decision in the American Smelting and Refining Company vs. Montana Department of Revenue of the State of Montana. We understand that the COST will file an amicus brief in support of the appellant's juriedictional statement. We also understand that Multistate Tax Commission will file an amicus brief in opposition to the appellant's jurisdictional statement. This will confirm that we consent to the filing of such briefs by COST AND MTC.

Yours very truly,
/s/ ROBERT W. CORCORAN
Robert W. Corcoran
Chief Tax Counsel

LAW OFFICES

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SUITE A - 406 FULLER AVENUE
HELENA, MONTANA 59601

October 28, 1977

Multistate Tax Commission

and

Committee on State Taxation of the
Council of State Chambers of Commerce

Gentlemen:

ASARCO, Inc. has filed an appeal to the United States Supreme Court from the Montana Supreme Court decision in the American Smelting and Refining Company vs. Montana Department of Revenue of the State of Montana. We understand that the Committee on State Taxation ("COST") and the Multistate Tax Commission (MTC) both respectively wish to file an amicus brief in support and in opposition of and to the appellant's jurisdictional statement in that case. This will confirm that we consent to the filing of such briefs by COST and MTC.

Very truly yours,
/s/ GEORGE T. BENNETT
George T. Bennett
of Counsel for ASARCO